IN THE

Supreme Court of the United States

OCTOBER TERM 1978

No. 78-1173

MACLIN P. DAVIS, JR. AND
DOROTHY S. DAVIS; LAURENCE
B. HOWARD, JR. AND CORNEILLE
T. HOWARD; ALLAN MURPHY AND
ESTATE OF MARION E. MURPHY
BY ALLAN MURPHY, EXECUTOR,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioners pray that a Writ of Certiorari be issued to review the Orders of the United States Court of Appeals for the Sixth Circuit entered on October 27, 1978 and December 5, 1978.

CITATIONS TO ORDERS AND OPINIONS BELOW

The Decision of the United States Tax Court was adverse to the taxpayer. The Tax Court's Opinion has been officially reported at

66 T.C. 260 (1970).[1] A three judge panel of the Court of Appeals for the Sixth Circuit affirmed the Tax Court's Decision. The Court of Appeals' Decision has been unofficially reported at 42 A.F.T.R.2d 78-6120 and 78-2 U.S.T.C. ¶9776.[2] on December 5, 1978, the Court entered an Order denying the Petitioners' Petition for Rehearing.[3]

JURISDICTION

The Orders of the Court of Appeals were entered on October 27, 1978 and December 5, 1978, respectively. The jurisdiction of this Court is envoked under 28 U.S.C. §1254(1).

THE QUESTION PRESENTED

If this Honorable Court grants the Petitioners' request to review the Order of the Court of Appeals for the Sixth Circuit, the following question will be presented to this Court on the Writ of Certiorari:

> Did the Tax Court and the Court of Appeals incorrectly decide that the Taxpayers were not owners of apartments built with loans insured by the Federal Housing Authority, and therefore not entitled to depreciation and mortgage interest ~~depreciations.~~ deductions.

STATUTES INVOLVED

The statutes involved are sections of the Internal Revenue Code of 1954, as amended, which is codified as Title 26 of the United States Code. The sections relied upon by Petitioners are as follows:

SEC. 163. GENERAL RULE.

> There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * *

[1] The Tax Court's Decision is printed as Appendix A to this petition.

[2] The Opinion of the Court of Appeals is printed as Appendix B to this petition.

[3] That Order is reprinted as Appendix C to this petition.

SEC. 167. DEPRECIATION.

> (a) General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business,
>
> or
>
> (2) of property held for the production of income.

* * *

STATEMENT

The Petitioners[4] were shareholders[5] in Harpeth Homes, Inc., Bedford Manor, Inc. and Urban Manor East, Inc. Each corporation was formed for the purpose of constructing, developing and operating an apartment complex. In order to accomplish their stated purpose, each corporation obtained a mortgage loan to finance 100% of the construction costs. Each corporation also entered into substantially similar regulatory agreements with the Federal Housing Authority which insured the mortgagee's loans.

These agreements provided that the Federal Housing Commissioner's approval would be required for the adoption of rental schedules; the conveyance, transfer and encumbrance of the property; the assignment, transfer, or encumbrance of any personal property of the Project, including rent; the payout of any funds other than reasonable operating expenses and necessary repairs, except surplus cash, such distribution or payout not to exceed 6% on the equity investment in any fiscal year; the entering into any contracts for supervisory or managerial services; and the undertaking of any other business

[4] Petitioners Dorothy S. Davis and Corneille T. Howard are parties to this lawsuit only because they filed joint federal income tax returns with their spouses, Maclin P. Davis, Jr. and Laurence B. Howard, respectively for the year in question. The Estate of Marion E. Murphy is a party because pursuant to Sections 1 and 2 of the Internal Revenue Code of 1954, it filed a joint federal income tax return with petitioner Allan Murphy. Until a Court decree was entered in August of 1969, the Estate was owner of two parcels of real estate involved in this case. At that time ownership was transferred to Marion E. Murphy's surviving husband, petitioner Allan Murphy.

[5] Two additional shareholders did not contest the Commissioner's determination and are not parties to this lawsuit.

activity on the part of the mortgagor. The mortgagor's rights to the rentals, profits, income and any other charges which they were entitled to receive or might be entitled to receive from the operation of the mortgaged property was assigned and pledged to the Commissioner as security.

In addition to the Commissioner's approval for any distribution or payout in excess of 6% from surplus cash, the Commissioner's approval was also required before any distributions could be made from residual receipts. Surplus cash was defined as the cash (exclusive of any special funds and tenants' security deposits) remaining after payments of amount due on the mortgage note, deposits to reserves and all other obligations of the apartment complex. Any cash remaining after payment of distributions from surplus cash constituted residual receipts.

After obtaining the federally insured loans, each corporation built an apartment complex which had the same basic name as the corporations.

The shareholders of Bedford Manor, Inc. entered into an agreement with the corporation dated September 18, 1969, that provided for the transfer of the Bedford Manor Apartments to the shareholders. Simultaneously, Urban Manor East, Inc. conveyed the Urban Manor East Apartments to its shareholders. On January 31, 1969, the Hillside Manor Apartments were transferred by Harpeth Homes, Inc. to its shareholders. Title was conveyed by Quitclaim Deed with the shareholders taking title as tenants-in-common with their interest in proportion to the stock ownership that each had in the corporations. The transfer contained the following provisions:

1. The transferor corporation had responsibility for managing the apartments.

2. The conveyance subject to the mortgage encumbering the real estate.

3. The corporations remained liable on the note secured by the mortgage although the real estate remained subject to the mortgage lien to secure the mortgage payments;

4. The shareholders were not liable for any payment on the note; however, the apartments were subject to being sold to pay said note;

5. The regulatory agreement between the grantor and the Federal Housing Authority was to remain in effect and the obligations of the grantor thereunder were not to be impaired;

6. The grantor was to manage the real estate, obtain tenants, collect rents, be responsible for repairs and maintenance expense, and out of said rents pay taxes on the real estate, make payments on the mortgate, pay insurance premiums for property damage covering the value of the improvements on the property and its contents and for liability coverage protecting grantees and grantors up to at least $500,000, pay grantee the maximum amount allowed to be paid out by the Federal Housing Authority and retain the residual receipts in accordance with said regulatory agreement;

7. When the residual receipts or any portion thereof were authorized to be released by the Federal Housing Authority, the released receipts were to be the property of the corporation;

8. If the Federal Housing Authority objected to the transfer, the shareholders were obligated to reconvey the property to the corporations.

At the time of the transfers, the Federal Housing Authority was informed of the conveyance. After being informed of the proposed conveyances, the area director of the Federal Housing Authority informed one of the petitioners that the Federal Housing Authority did not anticipate any objection to retroactive approval of the transfer of the properties.

The various tax returns were prepared on the basis that the corporations would report all income from rents, deducting therefrom operating expenses and the amount paid for interest and amortization of the loans. The amounts paid on account of the loans were reflected as gross income on the returns of the partnerships. The partnerships then deducted mortgage interest and depreciation together with any incidental expenses resulting in a net operating loss which was allocated among the partners. Upon audit, the Commissioner disallowed the deductions on the basis that the partnerships did not own the property. Although the Tax Court and the Sixth Circuit sustained the Commissioner, both Courts recognized that the Quitclaim Deeds, although unrecorded, were effective to transfer the apartments ownership interest to the partnerships from the corporations.

REASONS FOR GRANTING THE WRIT

The Decisions below should be reviewed pursuant to Supreme Court Rule 19(1)(b) because the Court of Appeals has decided a federal question in conflict with the Decision of this Court in *Frank Lyon Company* v. *United States*, ______, U.S. ______, 98 S. Ct. 1291 (1978). In addition, the Court of Appeals decided contrary to the intentions of Congress an important question of federal law concerning ownership of the Federal Housing Authority insured housing.

BY RULING THAT THE TAXPAYERS WERE NOT ENTITLED TO THE TAX BENEFITS DESPITE THEIR OWNERSHIP OF THE REAL PROPERTY, THE COURT OF APPEALS DECIDED THE CASE IN CONFLICT WITH THE RATIONALE OF THIS COURT IN *FRANK LYON COMPANY;* AND DECIDED THE CASE IN CONFLICT WITH THE INTENT OF CONGRESS IN ESTABLISHING THE INSURED HOUSING PROVISIONS.

In deciding the instant case, the Court of Appeals while recognizing that the Quitclaim deeds were effective to transfer legal and beneficial ownership to the taxpayers, denied the petitioners the benefits of deducting depreciation and mortgage interest. These deductions are commonly associated with ownership of property. In deciding against the taxpayers, the Court of Appeals relied heavily on distinguishing *Frank Lyon Compnay* v. *United States*, ______ U.S. ______, 98 S. Ct. 1291 (1978), from the present case.

The Court's first distinction was that while the taxpayer in *Frank Lyon Company, supra*, was liable on the mortgage note, the present taxpayers were not liable. *Maclin P. Davis, Jr., et. al.* v. *Commissioner, supra*, Appendix B, p. B-14. The taxpayers assert that this distinction is not consistent with the facts. The taxpayers' property was subject to the liability. To say that the taxpayers are not liable on the mortgage but that their property is subject to the mortgagee's lien, is to ignore the realities of the situation. Just as the taxpayer's financial position in *Frank Lyon Company* is affected by the assumed long-term debt despite the offsetting presence of the building, the present taxpayers while owning the apartment complexes assumed the risk of losing the assets through foreclosure of

the mortgage liens. Although *Frank Lyon Company* was liable for the mortgage, while our taxpayers took property subject to the mortgage, the difference is not significant since the property in each case would have more than satisfied the outstanding liability. Moreover, the *Frank Lyon Company* had no exposure on the mortgage since it was less than 100% financing and involved commercial property which appreciates more rapidly than the low-cost subsidized housing in the present situation. Finally, the Court completely ignores the original nonrecourse nature of the loans. In other words, there was no personal liability to assume. To obtain personal liability beyond the value of the property, a novation of the mortgage would be required.

The Court of Appeals' second distinction was that the accounting in the *Frank Lyon Company* case was consistent with a sale-leaseback, while in the instant case the accounting merely "confused matters." As the Tax Court noted, the Commissioner did not use his powers under Section 482 to readjust the transaction, but merely tried to say that the transaction was a sham. Thus, this purported distinction is without merit and obviously created to support their departure from a prior decision of this Court. In addition, the present case does not involve a sale-leaseback, but a sale with the transferors retaining a managment responsibility. The accounting treatment which reported payments on the mortgage as income to the partners is certainly consistent with the ownership interest held by the partners who received the benefit of capital appreciation and mortgage reduction.

The Court of Appeals found that a third controlling distinction from the *Frank Lyon Company* was that *Frank Lyon* involved unrelated parties while this case involved related parties. While the taxpayers in this case controlled the corporations, the Court of Appeals seems to say that this transaction was not one that would have been negotiated if the parties had been unrelated. The Court fails to look beyond its conclusion to the actual substance and reality of the transaction. In this case, not only did the corporation benefit by no longer being responsible for Tennessee Franchise and Excise Taxes, the shareholders acquired the possibility of individually participating in the property's equity growth through either reduction of the mortgage principal or its appreciation in value. Moreover, the Court of Appeals' distinction overlooks the fact that each corporation and partnership involved shareholders and individuals who were unrelated and were obviously dealing among themselves at arm's length. For instance,

petitioner Maclin P. Davis, Jr., never owned more than a 10% interest in any of the involved corporations or partnerships. See Tax Court Decision Appendix A, p. A-3. Certainly Mr. Davis was not going to risk his ownership interest to satisfy the demand of the other parties.

Thus, a review of the purported distinctions relied upon by the Court of Appeals to decide this case contrary to this Court's decision in *Frank Lyon Company* v. *United States, supra,* clearly shows that this Court should grant the Writ of Certiorari to correct the decision of the Court of Appeals. The review is necessary to correct the conflict between this Court's decision in *Frank Lyon Company* v. *United States, supra,* and the Court of Appeals' decision in the present case.

An additional reason for granting the Writ of Certiorari is that by its decision the Court of Appeals has severely limited the congressional intent that investors in Federal Housing Authority insured property can be attracted through the use of tax benefits. As the Tax Court noted on page 270 of its decision, Footnote 3, the tax shelters available under Section 236 of the National Housing Act reflected a deliberate congressional reliance on nonrecourse loans to create tax losses to add to investors profits. While the Court of Appeals, *Davis, Jr., et. al.* Appendix B, p. B-9, Footnote 7, acknowledged this intent on the part of Congress, it ignored the substance and realities of the present transaction contrary to the congressional intent expressed in the National Housing Acts. Thus, by misconstruing the *Frank Lyon Company* case, the Court of Appeals has justified overruling a deliberate congressional decision to make tax benefits available for low cost housing so that investors would pursue such equity investments. Consequently, this Court should grant the Writ of Certiorari to ensure that the congressionally mandated policy is followed.

CONCLUSION

For the reasons previously set forth, the petitioners respectfully request that a Writ of Certiorari be granted to review the Order of the United States Court of Appeals for the Sixth Circuit which affirmed the Order of the United States Tax Court.

Respectfully submitted,

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APPENDICES

66 T. C. No. 29

UNITED STATES TAX COURT

MACLIN P. DAVIS, JR. AND DOROTHY S. DAVIS;
LAURENCE B. HOWARD, JR. AND CORNEILLE T. HOWARD;
ALLAN MURPHY AND ESTATE OF
MARION E. MURPHY BY ALLAN MURPHY,
Executor, Petitioners
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 2915-74.

Filed May 17, 1976.

Each of the corporate grantors built a rental apartment project under a loan guarantee program administered by FHA. The management of the properties, rentals to be charged, transfer of ownership and withdrawal of funds, inter alia, were subject to control by FHA. The corporate grantors gave quitclaim deeds to the stockholders, subject to an agreement reserving to the grantors all rights and obligations except the right to receive "surplus cash" generated by rentals, of the property. Approval of the transfer was not obtained from FHA. *Held,* the stockholders did not acquire a present interest in the property and could not deduct the losses resulting therefrom. *David F. Bolger,* 59 T.C. 760 (1973), distinguished.

H. Stennis Little, Jr. and *William B. Owen,* for the petitioners.

John B. Harper, for the respondent.

QUEALY, *Judge:* Respondent determined deficiencies in the income tax of peitioners for the taxable year 1969 as follows:

Petitioners	*Deficiencies*
Maclin P. Davis, Jr., et ux	$5,469.52
Laurence B. Howard, Jr., et al	5,839.43
Allan Murphy, et al	1,866.10

Petitioners joined in the filing of the petition pursuant to Rule 61(a), Tax Court Rules of Practice and Procedure.

Certain of the adjustments to income in the respective notices of deficiencies have not been contested by the parties, leaving for consideration the sole question whether the petitioners, as partners, are entitled to deduct the losses incurred in the taxable year 1969 from the operation of certain apartment projects in which the petitioners, or the corporations in which petitioners were stockholders, had an interest.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulations of facts and the exhibits attached thereto are incorporated herein by this reference.

Petitioners, Maclin P. Davis, Jr., and Dorothy S. Davis, are husband and wife. At the time the petition in this case was filed, they resided at Nashville, Tennessee. They filed a timely individual income tax return (Form 1040) for the taxable year 1969 with the Director of the Southeast Service Center at Chamblee, Georgia.

Petitioners, Laurence B. Howard, Jr., and Corneille T. Howard, filed a joint individaul income tax return (Form 1040) for the taxable year 1969, with the Director of the Southeast Service Center at Chamblee, Georgia.

Petitioner Laurence B. Howard, Jr., resided at Nashville, Tennessee, on the date the petition in this case was filed. Petitioner Corneille T. Howard resided at Franklin, Tennessee, on the date the petition was filed.

Petitioner Allan Murphy and his late wife, Marian E. Murphy, filed a joint individaul income tax return (Form 1040) for the taxable year 1969 with the Director of the Southeast Service Center at Chamblee, Georgia. Allan Murphy resided at Nashville, Tennessee, on the date the petition was filed.

Harpeth Homes, Inc., is a Tennessee corporation incorporated on July 6, 1966. The corporation was formed for the purpose of

constructing, developing and operating an apartment project in Williamson County, Tennessee, known as Hillside Manor Apartments. On November 19, 1969, for its fiscal year ended May 31, 1969, Harpeth Homes, Inc., filed a U.S. Corporation Income Tax Return (Form 1120) with the Director of the Southeast Service Center at Chamblee, Georgia.

Bedford Manor, Inc., is a Tennessee corporation incorporated on December 11, 1967, for the purpose of constructing, developing and operating an apartment complex in Bedford County, Tennessee, known as Bedford Manor Apartments. For its fiscal year ended September 30, 1969, Bedford, Manor, Inc., filed a U.S. Corporation Income Tax Return (Form 1120) on March 16, 1970, with the Director of the Southeast Service Center at Chamblee, Georgia.

Urban Manor East, Inc., is a Tennessee corporation incorporated on December 11, 1967, for the purpose of constructing, developing and operating an apartment complex located in Davidson County, Tennessee, known as Urban Manor East Apartments. For its fiscal year ended January 31, 1970, Urban Manor East, Inc., filed a U.S. Corporation Income Tax Return (Form 1120) on March 27, 1970, with the Director of the Southeast Service Center at Chamblee, Georgia.

At all times material herein, the stockholders of and their respective percentages of stock holdings in Harpeth Homes, Inc., Bedford Manor, Inc., and Urban Manor East, Inc., were:

Stockholder	*Harpeth Homes, Inc.*	*Bedford Manor, Inc.*	*Urban Manor East, Inc.*
Laurence B. Howard, Jr.	64%		
Nancy Howard or Laurence B. Howard, Jr.		67%	30%
Gerson Schklar	16%		
Triangle Construction Company		15%	30%
Allan Murphy	16%	10%	30%
Maclin P. Davis	4%	8%	10%
Totals	100%	100%	100%

On July 26, 1966, Harpeth Homes, Inc., obtained a mortgage loan of $505,800 from the Glen Justice Mortgage Company, Inc., of Dallas, Texas, to finance 100 percent of the construction costs of an apartment complex. Harpeth Homes, Inc., through its President, Laurence B.

Howard, Jr., executed a "regulatory agreement" with the Federal Housing Administration (hereinafter referred to as "FHA") under which the FHA insured the $505,800 mortgage loan.

On January 18, 1968, Bedford Manor, Inc., obtained a mortgage loan of $1,181,300 from Guaranty Mortgage Company of Nashville, Tennessee, to finance 100 percent of the construction costs of an apartment complex. Bedford Manor, Inc., entered into a "regulatory agreement" with the Federal Housing Administration guaranteeing the payment of the loan to Guaranty Mortgage Company.

On January 18, 1968, Urban Manor East, Inc., obtained a mortgage loan of $714,000 from Guaranty Mortgage Company of Nashville, Tennessee, to finance 100 percent of the construction costs of an apartment complex. Urban Manor East, Inc., entered into a "regulatory agreement" with the FHA under which the FHA insured the loan from Guaranty Mortgage Company.[1]

In each case, the regulatory agreement provided that approval of the Federal Housing Commissioner shall be required for the adoption of rental schedules; the conveyance, transfer or encumbrance of the property; the assignment, transfer or encumbrance of any personal property of the project, including rent; the "pay out" of any funds, other than reasonable operating expenses and necessary repairs, except from "surplus cash," such distribution or "pay out" not to exceed six percent on the equity investment in any fiscal year; the entering into any contract for supervisory or managerial services; and the undertaking of any other business activity on the part of the mortgagor. As security, the agreement further provided for the assignment and pledge to the Commissioner of the rights of the mortgagor to the rentals, profits, income and any charges of whatever sort which they may receive or be entitled to receive from the operation of the mortgaged property.

"Surplus cash" was defined in the regulatory agreement as the cash (exclusive of any special funds and tenant security deposits) remaining

[1] The mortgage loans were insured under section 221(d)(3) of the National Housing Act (Housing Act of 1954, tit. I, sec. 123, 68 Stat. 601, 12 U.S.C. sec. 1715*l*(d)(3)). The subsidized interest program was extended by section 236 of the National Housing Act (Housing and Urban Development Act of 1968, tit. II, sec. 201(a), 82 Stat. 498, 12 U.S.C. sec. 1715*z*-1). See Housing and Urban Development Act of 1968, tit. II, sec. 201(c), 82 Stat. 502.

after payment of amounts due on the mortgage note, deposits to reserves, and all other obligations of the apartment complex. "Residual receipts," as used in the regulatory agreement, referred to any cash remaining after payment of distributions from "surplus cash." "Residual receipts" could not be distributed without prior written approval of the Federal Housing Commissioner. No distributions of "surplus cash" were ever made to petitioners from the income of the three apartment projects.

On September 18, 1968, the shareholders of Bedford Manor, Inc., entered into an agreement with that corporation which provided that the corporation would transfer the Bedford Manor Apartments to the shareholders and would thereafter manage the apartments as the agent of the shareholders.

The terms of said agreement were, as follows:

> 1. Grantor shall execute a deed conveying to Grantees as tenants in common Grantor's real estate at Shelbyville, Tennessee, subject to the mortgage encumbering said real estate.
>
> 2. Grantor shall continue to be liable on the note secured by said mortgage and said real estate shall continue to be subject to the mortgage lien to secure payments of said note.
>
> 3. Grantees shall not be liable for payment of said mortgage note, but said real estate shall be subject to being sold to pay said note.
>
> 4. The regulatory agreement between Grantor and the FHA shall remain in full force and effect without impairment of any of the obligations of Grantor thereunder.
>
> 5. Grantor shall manage said real estate, obtain tenants, collect rents, be responsible for maintenance and repairs at its expense, and, out of said rents, pay taxes on said real estate, make payments on said mortgage, pay insurance premiums for property damage coverage of the value of the improvements on said property and contents and liability coverage protecting Grantees and Grantor up to at least $500,000, pay Grantees the maximum amount allowed to be paid out by the FHA and retain the residual receipts in accordance with said regulatory agreement.

6. If and when said residual receipts, or any portion thereof, are released by the FHA, the portion of such receipts so released shall be the property of grantor.

7. If the FHA objects to said conveyance and has a lawful right to require that said real estate be conveyed back to grantor and requires that it be so conveyed, then said grantees shall convey said real estate back to grantor.

Similar agreements were entered into by Urban Manor East, Inc., and its shareholders with respect to the Urban Manor East Apartments on September 18, 1968, and by Harpeth Homes, Inc., and its shareholders with respect to the Hillside Manor Apartments on January 28, 1969.

On September 18, 1968, title to the Bedford Manor Apartments was conveyed by quitclaim deed from Bedford Manor, Inc., to Nancy Howard, Triangle Construction Company, Allan Murphy and Maclin P. Davis, Jr., as tenants-in-common with interests in proportion to the stock ownership of each in Bedford Manor, Inc.

On September 18, 1968, title to the Urban Manor East Apartments was conveyed by quitclaim deed from Urban Manor East, Inc., to Nancy Howard, Triangle Construction Company, Allan Murphy and Maclin P. Davis, Jr., as tenants-in-common with interests in proportion to the stock ownership of each in Urban Manor East, Inc.

On January 31, 1969, title to the Hillside Manor Apartments was conveyed by quitclaim deed from Harpeth Homes, Inc., to Gerson Schklar, Laurence B. Howard, Jr., Allan Murphy and Maclin P. Davis, Jr., as tenants-in-common with interests in proportion to the stock ownership of each in Harpeth Homes, Inc.

Nancy Howard was rendered unconscious as a result of an automobile accident on October 8, 1968, and died in December, 1968, without regaining consciousness. She died intestate, and her estate was administered in the Chancery Court of Davidson County, Tennessee. As part of this administration, a decree was entered by the court in August, 1969, approving the transfer of her interests in the real estate known as Bedford Manor Apartments and Urban Manor Apartments to Laurence B. Howard, Jr. The transfer of such real properties was accomplished by deeds from the Clerk and Master of the Chancery Court of Davidson County, Tennessee, to Laurence B. Howard, Jr., dated August 21, 1969.

The FHA was verbally informed of the proposed conveyance of the properties by each corporation to its shareholders at about the time of the execution and delivery of the quitclaim deeds. However, the parties did not at that time request the formal approval of the Federal Housing Commissioner for the conveyance by quitclaim deed of any interest in said properties to the respective shareholders.

On October 3, 1969, the Area Director for the FHA wrote to Maclin P. Davis, Jr., stating that the FHA did not anticipate any objection to retroactive approval of the transfer of the properties.

During 1969, the Bedford Manor Apartments, the Urban Manor East Apartments and the Hillside Manor Apartments were managed in the name of the three corporations as agents for the owners of the apartments under written management agreements entered into with the owners. The corporations, in turn, contracted with third parties for such management services.

The purpose of the conveyance of each of the apartment properties to the shareholders of each corporation was to enable the shareholders to deduct the operating losses on their individual returns.

At the times when the quitclaim deeds to the apartment properties were granted by the corporations to their shareholders, the respective fair market values of the real properties were at least equal to the outstanding mortgage liabilities encumbering such properties.

On February 21, 1973, an application for transfer of physical assets of Bedford Manor, Inc., was filed with the Department of Housing and Urban Development. The mortgagor-seller was shown on the application to be "Bedford Manor, Inc. (additional sellers—L. B. Howard, Jr. and Allan Murphy)." The purchaser was identified as Bedford Manor Apartments Company, a partnership composed of Triangle Construction Company, Inc., and Maclin P. Davis, Jr. The agreement was executed by Laurence B. Howard, Jr., and Allan Murphy and by Laurence B. Howard, Jr., on behalf of Bedford Manor, Inc.

On March 13, 1973, Bedford Manor, Inc., Triangle Construction Company, and petitioners Allan Murphy, Maclin P. Davis, Jr., and Laurence B. Howard, Jr., executed and delivered a bill of sale and a warranty deed transferring their interest in the personalty and realty of the Bedford Manor project to Bedford Manor Apartments Company, the partnership. Bedford Manor, Inc., warranted the title to the realty

transferred. The execution and delivery of the bill of sale and warranty deed were pursuant to a sale contract entered into between the parties (excepting Maclin P. Davis, Jr., as a seller) on February 14, 1973.

On March 14, 1973, Bedford Manor Apartments Company entered into a regulatory agreement relating to the mortgage loan on the Bedford Manor property. Written approval (as contemplated in the regulatory agreement) of a transfer of the physical assets of Bedford Manor, Inc., to Bedford Manor Apartments Company, the limited partnership, was given by the Department of Housing and Urban Development on March 23, 1973.

On May 15, 1973, Urban Manor East, Inc., and Urban Manor East, a limited partnership composed of Laurence B. Howard, Jr., and Allan Murphy, general partners, and Maclin P. Davis, Jr., limited partner, and the Secretary of Housing and Urban Development, executed a "release agreement" wherein the corporation was relieved of all its obligations under the note dated January 18, 1968, and the partnership assumed certain obligations under the note, the deed of trust, and the regulatory agreement. The release agreement was executed pursuant to an "assumption agreement" of the same date. Under the assumption agreement, the limited partnership did not assume personal liability for payments due under the note.

On May 15, 1973, Allan Murphy, Maclin P. Davis, Jr., Laurence B. Howard, Jr., Triangle Construction Company, and Laurence B. Howard, Jr., on behalf of Urban Manor East, Inc., executed a warranty deed conveying their interest in the real property of Urban Manor East Apartments to Urban Manor East, the limited partnership.

On June 5, 1973, Laurence B. Howard, Jr., Allan Murphy, Maclin P. Davis, Jr., Triangle Construction Company and Urban Manor East, Inc., executed and filed with the Department of Housing and Urban Development an application for transfer of the physical assets of Urban Manor East, Inc. Written approval (as contemplated in the regulatory agreement) of the transfer was given by the Department of Housing and Urban Development on July 16, 1973. The approved transferees were Laurence B. Howard, Jr., and Allan Murphy, general partners, and Maclin P. Davis, Jr., a limited partner, operating as Urban Manor East.

At the time of the trial in this case, no approval of any transfers of

the physical assets of Harpeth Homes, Inc., had ever been given by the FHA or the Department of Housing and Urban Development.

Harpeth Homes, Inc., filed its income tax returns on the basis of a fiscal year ended May 31. Hillside Manor Apartments, a partnership composed of the shareholders of Harpeth Homes, Inc., filed its partnership income tax returns on the basis of a calendar year.

In its income tax return for the fiscal year ended May 31, 1969, Harpeth Homes, Inc., reported the gross rents from Hillside Manor Apartments in the amount of $46,389.56, from which it claimed deductions of $45,534.10. For the fiscal year ended May 31, 1970, Harpeth Homes, Inc., reported gross rents of $47,167.39, from which it claimed deductions of $52,051.59.

In the partnership return of Hillside Manor Apartments, a partnership composed of the shareholders of Harpeth Homes, Inc., for the taxable year 1969, there was reported rental income of $18,107.18, from which there were deducted interest of $12,444.08 and depreciation of $11,845.00, resulting in a net loss of $6,181.90. The net loss was allocated among the partners, as follows:

Partner	*Loss*
Laurence B. Howard, Jr.	$3,956.42
Allan Murphy	989.10
Gerson Schklar	989.10
Maclin P. Davis, Jr.	247.28
Total	$6,181.90

Urban Manor East, Inc., filed its income tax returns on the basis of a fiscal year ended January 31. Urban Manor East Apartments, a partnership composed of the shareholders of Urban Manor East, Inc., filed its partnership income tax returns on the basis of a calendar year.

In its income tax return for the fiscal year ended January 31, 1970, Urban Manor East, Inc., reported gross rents from Urban Manor East Apartments in the amount of $54,966.21, from which it claimed deductions of $56,184.34.

In the partnership return of Urban Manor East Apartments, a partnership composed of shareholders of Urban Manor East, Inc., for the taxable year 1969, there was included rental income of $21,247.00, from which there were deducted depreciation, interest and other

expense of $59,928.00. The resulting loss was allocated among the partners, as follows:

Partner	*Loss*
Laurence B. Howard, Jr.	$ 4,177.80
Laurence B. Howard, Jr., Adm. Estate of Nancy C. Howard	7,427.20
Triangle Construction Company	11,604.00
Allan Murphy	11,604.00
Maclin P. Davis, Jr.	3,868.00
Total	$38,681.00

Bedford Manor, Inc., filed its income tax returns on the basis of a fiscal year ended September 30. Bedford Manor Apartments, a partnership composed of the shareholders of Bedford Manor, Inc., filed its partnership income tax returns on the basis of a calendar year.

In its amended income tax return for the fiscal year ended September 30, 1969, Bedford Manor, Inc., reported gross rents from Bedford Manor Apartments in the amount of $44,021.87, from which it claimed deductions of $43,980.95. For the fiscal year ended September 30, 1970, Bedford Manor, Inc., reported gross rents of $129,867.10, from which it claimed deductions of $137,607.12.

In the partnership return of Bedford Manor Apartments, a partnership composed of the stockholders of Bedford Manor, Inc., for the taxable year 1969, there was reported rental income of $16,253.00, from which there were deducted depreciation, interest and other expense of $104,901.00. The resulting loss of $88,648.00 was allocated among the partners, as follows:

Partner	*Loss*
Laurence B. Howard, Jr.	$21,401.00
Laurence B. Howard, Jr., Adm. Estate of Nancy C. Howard	37,993.00
Triangle Construction Company	13,297.00
Allan Murphy	8,865.00
Maclin P. Davis, Jr.	7,092.00
Total	$88,648.00

The foregoing returns were prepared on the basis that the corporations should report all income from rents, deducting therefrom operating expenses and the amounts paid for interest and amortization of the loans. The amounts paid on account of the loans were reflected as gross rents on the returns of the partnerships. From these amounts, there were deducted interest and depreciation, together with any incidental expenses incurred by the partnerships.

OPINION

In these cases, there is presented a familiar pattern involving the construction of rental housing, pursuant to programs initiated by the Federal Housing Administration, with financing to be provided in the name of a corporation formed for that purpose, and with whatever interest may have remained in the property to be transferred to designated individuals as partners or co-owners in order that such individuals may have the benefit of the deductions attributable to ownership of the property. Accordingly, petitioners contend that the result is controlled by the opinion of this Court in *David F. Bolger*, 59 T.C. 760 (1973).[2]

The respondent concedes that under Tennessee law, an unrecorded quitclaim deed is effective to transfer all of the grantor's right, title and interest in such property to the grantee. Accepting this, respondent argues that due to the restrictions imposed by the regulatory agreements, which were required in order to obtain the financing of these properties, the transfers were lacking in reality. Similar restrictions were imposed by the lenders in the *Bolger* case. The mere fact that any transfer was subject to the approval of the FHA does not preclude an effective transfer being made prior to such approval. *Howard R. Ward*, 48 T.C. 803 (1967); see also *William T. Male*, T.C. Memo 1971-301, affd. per curiam 473 F.2d 908 (4th Cir. 1973).

The respondent points to the fact that in the filing of the returns for the corporations and the respective partnerships involved in this proceeding, petitioners adopted a "bizarre" method of accounting for

[2] The facts are distinguishable from *William B. Strong*, 66 T.C. 12 (1976), in that there the property in question was not formally transferred to the individuals by quitclaim deed.

the gross rents. It is impossible from the record to determine whether such method, though patently erroneous, produced a result different from that which would follow if all income and expenses were reflected in the petitioners' returns. If not, respondent could and should have made the necessary adjustments.

The respondent further argues that the transfers were lacking in substance because the primary or sole purpose for the granting of the quitclaim deeds was to transfer to the individual partners the deduction of losses which would be incurred on account of interest and depreciation. While the respondent's argument may be factually correct, the fact that the transfers were motivated by tax considerations does not afford a basis for distinguishing the *Bolger* case. In fact, the result sought to be achieved by the petitioners here is in accord with the intent of the Congress.[3]

As this Court pointed out in the *Bolger* case, our decision must turn on the question whether, by the quitclaim deeds, the grantees acquired a sufficient interest in the properties to warrant the deduction by them of depreciation and mortgage interest. The parties have agreed that under Tennessee law an unrecorded quitclaim deed is sufficient to transfer an interest in property to the grantee.

A simple transfer by quitclaim deed pursuant to which the grantees might take the property subject to (but not assuming) the obligations imposed in the regulatory agreements would presumably vest in the grantees ownership of the fee and all rights incident thereto. The grantor corporation would become a mere "shell" or nominee. Gross rents would be chargeable in the first instance to the grantees, from which would be deductible all expenses attributable to the properties, including management fees, depreciation, and interest.

If all we had was a naked quitclaim deed, the result might well be governed by our decision in the *Bolger* case. If so, it would also follow that gross rentals would likewise be chargeable to the grantees. In this case, however, the quitclaim deed was restricted by agreement

[3] In a report entitled "Overview of Tax Shelters," prepared by the Joint Committee on Internal Revenue Taxation for the use of the Committee on Ways and Means, dated September 2, 1975, at 18, n.1, the following is noted:

> The "pure" tax shelter available to subsidized low-income housing under section 236 of the National Housing Act reflected in fact a deliberate congressional reliance on the use of nonrecourse loans to create tax losses whose shelter effect would add to the investors' profits.

between the grantors and the grantees. The grantees were apparently unwilling to assume responsibility of accounting for the gross rents.[4]

The terms of the agreements have been set forth in our findings. As construed by the parties, the gross rents from the properties accrued to the corporate grantors. The obligation to make the payments on the indebtedness, both with respect to principal and interest, remained that of the corporate grantors. Any so-called "residual receipts" which could not be paid out were to be retained by the corporate grantors. All that the petitioners acquired was the right to receive the pay out of "surplus cash" defined as "the maximum amount allowed to be paid out by the FHA" pursuant to the regulatory agreement. As stockholders of the corporate grantors petitioners already had that right. The quitclaim deeds merely gave the stockholders the security of a direct claim on the funds available for distribution.

The burden was on the petitioners to show that the retention of "residual receipts" by the corporate grantors was *in substance*, as well as *in form*, a management fee. Petitioners failed to meet this burden.

When the quitclaim deeds are thus considered in light of the agreement between the parties, restricting the rights to be acquired pursuant to those deeds, it cannot be said that petitioners acquired a depreciable interest in the properties. Their interests remained those of a stockholder, entitled only to the pay out of "surplus cash" in accordance with the regulatory agreements. If petitioners had intended to acquire a greater interest than that, it is clear that they could and would have done so. For the taxable year 1973, two of these properties were reconveyed to a new partnership. The reconveyance was approved by the FHA and the grantee partnerships assumed the obligations of the corporate grantors under the regulatory agreements.

Decision will be entered for the respondent.

[4] In *David F. Bolger*, 59 T.C. 760, 763 (1973), the transferees actually entered into an assumption agreement.

APPENDICES

No. 76-2283

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

MACLIN P. DAVIS, JR., and DOROTHY S. DAVIS; LAURENCE B. HOWARD, JR., and CORNEILLE T. HOWARD; ALLAN MURPHY and ESTATE OF MARION E. MURPHY by ALLAN MURPHY, Executor, *Appellants*, v. COMMISSIONER OF INTERNAL REVENUE, *Appellee*.	APPEAL from the United States Tax Court.

Decided and Filed October 27, 1978.

Before: EDWARDS and KEITH, Circuit Judges, and PECK Senior Circuit Judge.

PECK, Senior Circuit Judge. Petitioners-appellants, who are the taxpayers in the present case, have perfected this appeal from a decision of the Tax Court, which has held that the taxpayers could not legally deduct losses arising from the ownership and operation of apartment buildings and thus were liable, as had been determined by respondent-appellee Commissioner, for income tax deficiencies for the taxable year 1969, when the losses had been taken. *Davis, et al.* v. *Commissioner*, 66 T.C. 260 (1976). We affirm.

I

The present case arises out of the Commissioner's disallowance of what the taxpayers contend to be a legitimate real estate tax shelter. A more detailed statement of facts than provided in this opinion is reported in the Tax Court opinion. *Davis, et al.* v. *Commissioner, supra,* 66 T.C. at 261-69.

Harpeth Homes, Inc. was incorporated on July 6, 1966, for the purpose of constructing, developing, and operating an apartment complex to be known as Hillside Manor Apartments. Similarly, Bedford Manor, Inc. and Urban Manor East, Inc. were incorporated on December 11, 1967, for the purpose of constructing, developing, and operating, respectively, the Bedford Manor Apartments and the Urban Manor East Apartments. Taxpayers owned, in varying proportions, the stock of these three Tennessee corporations.[1]

On July 26, 1966, Harpeth Homes, Inc. obtained a mortgage loan to finance 100 percent of the construction costs of the apartment complex that it intended to construct, develop, and operate. In addition, Harpeth Homes, Inc. executed a regulatory agreement with the Federal Housing Administration (FHA) under which the FHA insured the mortgage loan. Likewise, on January 18, 1968, Bedford Manor, Inc. and Urban

[1] The Tax Court found that at all material times during the lawsuit, the relative stockholdings of the corporations were as follows:

Stockholder	*Harpeth Homes, Inc.*	*Bedford Manor, Inc.*	*Urban Manor East, Inc.*
Laurence B. Howard, Jr.	64%		
Nancy Howard or Laurence B. Howard, Jr.		67%	30%
Gerson Schklar	16%		
Triangle Construction Co.		15%	30%
Allan Murphy	16%	10%	30%
Maclin P. Davis	4%	8%	10%
Totals	100%	100%	100%

Gerson Schklar and Triangle Construction Co. are not petitioners-appellants in this case. Nancy Howard died as a result of an automobile accident in 1968. She died intestate, and her shares went to Laurence Howard following the administration of her estate.

Manor East, Inc. obtained mortgage loans to finance 100 percent of the construction costs of the apartment complexes that those two corporations intended to construct, develop, and operate, and also executed regulatory agreements with the FHA under which the FHA insured their loans.

The restrictions and obligations in the FHA regulatory agreements were quite similar in all three cases.[2] Each FHA agreement provided that as security for the FHA's insurance of the mortgage, the mortgagor corporation would assign and pledge to the Federal Housing Commissioner the rights of the mortgagor corporation to the rents, profits, incomes, and all other charges from the mortgaged property; permission was given by the FHA to the mortgagor corporation to collect and retain such rents, profits, income, and other charges unless and until a default be declared. Each FHA agreement also provided that written approval of the Federal Housing Commissioner was required to: (1) adopt rent schedules; (2) to convey, transfer, or encumber the rental properties; (3) to assign, transfer, or encumber any personal property of the project, including rent; (4) to pay any funds unless for reasonable operating expenses and necessary repairs; (5) to distribute funds to owners unless from "surplus cash" and unless limited to 6 percent of the equity investment per annum; (6) to contract for supervisory or managerial services; and (7) to undertake any other business activity by the mortgagor corporation. The agreements defined "surplus cash" as the cash remaining after subtracting (1) payments of amounts due on the mortgage and on all other obligations of the apartments, (2) deposits made to reserves, and (3) segregation of special funds and tenant security deposits. "Residual receipts" were defined as cash remaining after the payment of the unrestricted distribution from surplus cash. Because prior written approval of the Federal Housing Commissioner was required for any distribution of surplus cash that exceeded 6 percent of the equity in-

[2] The same agreement form was used.

vestment per annum, prior written approval of the Federal Housing Commissioner was, of course, required before any "residual receipts" could be distributed.

Following the execution of these financing arrangements, the apartment complexes were in fact constructed, developed, and put into operation by the corporations. Taxpayers then apparently decided that there was a distinct disadvantage to the corporate ownership of the apartment complexes. The losses anticipated from the first years of the operation of the apartments would not accrue to the taxpayers as shareholders, because as shareholders they could not take those corporate losses to offset portions of their individual incomes. Rather, the anticipated losses would accrue solely to the corporations, which had in this case no other income that the losses could offset.

Consequently, taxpayers sought to obtain ownership of the apartment complexes while retaining the advantages of the corporate structuring. The three corporations each entered into an "Agreement" with its shareholders, on September 18, 1968, in the case of Bedford Manors, Inc. and Urban Manor East, Inc., and on January 28, 1969, in the case of Harpeth Homes, Inc. In all three cases, the "Agreement" (hereinafter called the transfer and management agreement) provided that the grantor corporation would transfer title to the grantee shareholders (the taxpayers) and that grantor corporation would thereafter manage the apartments, assuming such responsibilities as collecting rents, maintaining and repairing the apartments, and paying the debt charges, taxes, and insurance premiums. In addition, however, each transfer and management agreement included provisions that seemed inconsistent with the status of the corporation as a mere managing agent for the grantee shareholders. The grantor corporation was to remain liable on the mortgage note; the grantee shareholders were not to be liable for payment of the mortgage note; the FHA regulatory agreement was to remain in full force and effect without impairment of any of the obli-

gations of the grantor corporation; and the grantor corporation was to pay the grantee shareholders the amount of the surplus cash permitted to be paid under the FHA regulatory agreement while keeping the residual receipts for itself.[3]

In accordance with the transfer and management agreements, the apartment complexes were conveyed by quitclaim deeds to the shareholders (the taxpayers) as tenants in common, with interests in proportion to the stock ownership of each shareholder. The consideration for passing title under each deed was $10 and "other good consideration." At the time of the conveyances, the fair market value of each of the apartment properties was at least equal to its outstanding mortgage liabilities.[4] The quitclaim deeds were not recorded.

The FHA was told of the conveyances of the properties by the corporations, but taxpayers did not request FHA approval. In October, 1969, the Area Director of the FHA did write to taxpayer Maclin P. Davis, stating that the FHA did not anticipate any objection to retroactive approval of the transfer of the properties but adding that the FHA did take cognizance of the fact that the taxpayers had ignored the FHA regulatory agreement.

In 1969, the apartment complexes were operated pursuant to the transfer and management agreements; the corporations subcontracted with third parties to provide the actual management services. On the income tax returns of the corporations, all gross rents from the properties were reported and most of the operating expenses were claimed as deductions. One deduction was called various names: "management fees," "fees paid to tenants in common," or "rental on apartment property." In reality, these "fees" were not fees at all but were the payments on the mortgage loans. After accounting for income and expenses, the corporations all reported losses

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[3] For the provisions of these agreements, *see* Part IV of this opinion.

[4] Consequently, there will be no issue in this case as to what footnote 37 meant in *Crane* v. *Commissioner*, 331 U.S. 1 (1947).

in 1969 and hence did not make any actual distributions of funds to taxpayers because there was no "surplus cash."

Taxpayers, in addition to filing individual returns, filed a partnership return for each of the apartment complexes. On the partnership returns, the so-called "fees" (the payments on the mortgage loans) were reported as rental income, against which the partnership deducted the interest portion of the loan payments made by the corporation and the depreciation on the apartment properties.[5] In 1969, all three partnership returns reported net losses, which were allocated among the taxpayers as partners. The taxpayers in turn reported their portion of the partnership losses on their income tax returns, deducting those amounts from their incomes.

In January, 1974, appellee Commissioner issued notices of deficiencies to taxpayers and notices of partnership audit changes. In the deficiency notices, taxpayers were informed that the Commissioner had disallowed the amounts taken by the taxpayers in 1969 as loss deductions. In the notices of partnership audit changes, taxpayers were informed that the partnerships could not claim any income and expenses, and the losses that had been allocated among the individual taxpayers were disallowed. The Commissioner stated in the notices that the arrangements between the corporations and its shareholders (the taxpayers) was a sham, noting that the individual taxpayers had taken the benefit of the loss deductions while the corporation continued to bear the burdens of ownership of the properties.[6] Taxpayers sought review in the Tax Court.

[5] The Bedford Manors partners also reported $2,000 in management expenses and $44 in miscellaneous expenses. The Urban Manor partners reported $20 in miscellaneous expenses.

[6] In a letter dated March 19, 1970, taxpayer Maclin P. Davis wrote the following to Mr. Hatton Hardison:

> The only substantial economic advantage to owning these apartments is to use the losses resulting from depreciation, interest payments and other deductible expenses as deductions on the income tax returns of the individual owners.

Taxpayers argued in the Tax Court that this case involved a quite legitimate arrangement of financial responsibilities and property interests for the construction, development, and operation of rental housing insured by the FHA. They denied that there was any legal problem under the tax law for the financing to be provided to a corporation formed for the purpose of constructing, and developing rental housing and, once the rental housing was constructed, for the equity interest in the housing to be transferred by quitclaim deed (which would be effective under state law to transfer the ownership interest) to the taxpayers as tenants in common in order that the taxpayers could have the benefit of the deductions attributable to the property. The taxpayers' understanding of the law was that their arrangement had been previously upheld in the Tax Court in *Bolger* v. *Commissioner*, 59 T.C. 760 (1973), and that as a result they had the right to take the loss deductions.

In *Bolger* v. *Commissioner, supra,* the Tax Court did in fact hold that the transfer of the ownership interests of a group of corporations in depreciable properties, which were subject to leases and mortgage indebtedness, to the corporations' shareholders was effective to grant to those shareholders the ownership interests in the properties such as to support the taken depriciation deductions. While the taxpayers rely heavily on *Bolger*, and the Commisisoner went to some lengths in attempting to distinguish it, the Tax Court adopted a different line of analysis in disallowing taxpayers' loss deductions. According to the Tax Court, the proper question to ask in this case was "whether, by the particular deeds, the grantees acquired sufficient interest in the properties to warrant deduction by them of the depreciation and mortgage interest." 66 T.C. at 271. The Tax Court concluded that there was not such a transfer because "the quitclaim deed was restricted by agreement between the grantors and the grantees." 66 T.C. at 271. The Tax Court stated:

> [According to the terms of the agreements] as construed by the parties, the gross rents from the properties accrued to the corporate grantors. The obligation to make the payments on the indebtedness, both with respect to principal and interest, remained that of the corporate grantors. Any so-called "residual receipts" which could not be paid out were to be retained by the corporate grantors. All that the petitioners acquired was the right to receive the payout of "surplus cash" defined as "the maximum amount allowed to be paid out by the FHA" pursuant to the regulatory agreement. As stockholders of the corporate grantors, petitioners already had that right. The quitclaim deeds merely gave the stockholders the security of a direct claim on the funds available for distribution.

66 T.C. at 271-72. The Tax Court thus held that no property interest passed to the taxpayers as shareholders because under the transfer and management agreement the corporations continued to be the real owners of the apartment complexes. Taxpayers sought review in this Court.

II

This Court in *Owens* v. *Commissioner*, 568 F.2d 1233 (6th Cir. 1977) at 1237, acknowledged that under *Gregory* v. *Helvering*, 293 U.S. 465 (1935), at 469, "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means by which the law permits, cannot be doubted," but then pointed out the limitation that the *Gregory* case itself places on that right. According to *Gregory*, "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." 293 U.S. at 469. *See Knetsch* v. *United States*, 364 U.S. 361, 366 (1960). What tax statutes do not intend is that taxpayers cast transactions in forms so as to come within their provisions when in fact there is no

substance behind the use of the forms, when the transaction is but a sham or when the economic reality of the transaction does not comport with the form. *Gregory* v. *Helvering, supra*, 293 U.S. at 469; *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 (1945); *Owens* v. *Commissioner, supra*, 568 F.2d at 1237; *Goldstein* v. *Commissioner*, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967).

In the present case, the Commissioner's determination of deficiencies rested upon the ground that the taxpayers' arrangements with their corporations were sham. The burden was thus on the taxpayers to prove that their transfer and management agreements were not shams. "It is established that the Commissioner's determination of deficiencies is presumed correct and the taxpayer has the burden of proof of showing it to be otherwise." *Coomes* v. *Commissioner*, 572 F.2d 554 (6th Cir. 1978). *See Welch* v. *Helvering*, 290 U.S. 111, 115 (1933); *Helvering* v. *Taylor*, 293 U.S. 507, 515 (1935); *Owens* v. *Commissioner, supra*, 568 F.2d at 1238. Taxpayers in this case have not carried the burden of proving that the Commissioner was incorrect in his determinations with respect to them.[7]

The arrangements taxpayers had with their corporations were one-sided to the advantage of the taxpayers. In absence of proof to the contrary, we must presume that this was due to the fact that the parties were corporations and their controlling shareholders. Corporations dealing at arm's length would not have made these deals.[8] With minimal investment,

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[7] The Tax Court was conscious of this problem, noting that Congress intended that there be a tax shelter for investors in low income rental housing. *Davis, et al.* v. *Commissioner*, 66 T.C. 260, 271 n. 3 (1976). However, while it is true that Congress has appeared to approve the use of this shelter in order to attract investment, it does not follow that Congress has legislated the sham doctrine out of existence with respect to cases such as the one before us. Congress approved the taking of losses by owners of low income rental housing, not agreements that do not truly transfer ownership rights.

[8] This conclusion assumes that the corporations, while controlled by the taxpayers, could not be disregarded as separate entities under the tax laws. The corporations did, after all, have business purposes.

consisting of a few dollars and a contingent need to pay the mortgage in order to keep the property, taxpayers purported to acquire from the corporations the ownership of the apartments and thereby the right to claim interest and depriciation deductions worth tens of thousands of dollars, creating loss deductions to "shelter" other income of theirs.

The one-sided character of the arrangement before us can be seen in a different way. Normally, such arrangements are financing tools for businesses owning income-producing property. Cary, "Corporation Financing through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations," 62 Harv.L.Rev. 1 (1948). In this case, however, the corporations did not obtain a sum of money under the transfer and management agreements. Even before the transfer, the corporations had the right to any income produced by the properties.

The transfer and management agreements thus could not have been intended to achieve an arm's-length business arrangement, but rather were executed to obtain an advantageous tax situation for taxpayers. *See May* v. *Commissioner*, 41 P-H T.C. Memo ¶ 72,070 (Tx. Ct. 1972) (depreciation deduction denied because taxpayer had no interest in television films; transaction never intended to achieve an arm's-length sale and purchase of films, but rather an advantageous tax situation). Under *Gregory* v. *Helvering, supra,* 293 U.S. 465, they were transactions not intended by the loss deduction provision to alter tax liability. Therefore, the claimed loss deductions must be denied and the Commissioner's determination of deficiencies upheld. *See Southeastern Canteen Co.* v. *Commissioner,* 410 F.2d 615, 619-20 (6th Cir.), *cert. denied,* 396 U.S. 833 (1969). The Commissioner's power under § 482 of the Internal Revenue Code of 1954, 26 U.S.C. § 482, to

The test in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436, 438-39 (1943), was therefore satisfied. *See Burnet* v. *Commonwealth Improvement*, 287 U.S. 415 (1932); *Bolger* v. *Commissioner*, 59 T.C. 760 (1973). Compare *Owens* v. *Commissioner*, 568 F.2d 1233 (6th Cir. 1977).

reallocate income and deductions between businesses owned by related parties reinforces this conclusion.[9] The regulations under that section recognize that such reallocation is appropriate when there is a lack of an arm's-length deal involving related parties.[10]

This result is supported by a line of similar cases that involved sale-and-leasebacks between related parties and that the courts called shams. These cases hold that when a transfer is made between related parties and has no utilitarian business purpose, in reality there has been simply a camouflaged assignment of income and the arrangement must be disregarded for tax purposes. *Mathews* v. *Commissioner*, 520 F.2d 323, 324-25 (5th Cir. 1975), *cert. denied,* 424 U.S. 967 (1976);

[9] Section 482 of the Internal Revenue Code of 1954, 26 U.S.C. § 482, provides:

§ 482. Allocation of income and deductions among taxpayers

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Aug. 16, 1954, c. 736, 68A Stat. 162; Oct. 4, 1976, Pub.L. 94-455, Title XIX, § 1906(b)(13)(A), 90 Stat. 1834.

[10] *See* Regulation 1.482-1(a)(6), which provides:

(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

W. H. Armstron v. *Commissioner,* 188 F.2d 531, 533 (5th Cir. 1951); *White* v. *Fitzpatrick,* 193 F.2d 398 (2d Cir. 1951), *cert. denied,* 343 U.S. 928 (1952). This rule has been said to be supported by the principles governing intramarital transfers of income. *Helvering* v. *Clifford,* 309 U.S. 331 (1940); *White* v. *Fitzpatrick, supra,* 193 F.2d at 401. In *Clifford,* the Supreme Court held that a husband who had assigned securities to a trust, the net income of which was to go to his wife, was to be taxed on the income of the trust because his control of the trust was such that he owned, for tax purposes, the securities in the trust. A "manager," who retains such control over the estate in a situation when there is business purpose lacking is like the husband in *Clifford,* the real owner of the property.

The difference between these cases and the one before us is that at stake here is the assignment of losses instead of the assignment of income. The controlling parties, the taxpayers, wanted ownership status in order to get the benefit of loss deductions, whereas in sale-and-leaseback cases involving related parties and the lack of business purpose, the controlling parties wanted lessee status in order to get the benefit of deductions from income. In both situations there is the lack of arm's-length dealing. *See Mathews* v. *Commissioner, supra,* 520 F.2d 325. It is just that in the present case, the taxpayers used their control of the situation to transfer title by a deal that placed all the burdens of ownership on the corporations while keeping tax benefit for themselves.

III

Two cases, *Frank Lyon Co.* v. *United States,* — U.S. —, 98 S.Ct. 1291 (1978), and *Bolger* v. *Commissioner, supra,* 59 T.C. 760, at first blush appear to reach a result inconsistent with ours. However, while both cases present similar circumstances in many respects, they are factually and legally distinguishable from the present case.

In *Frank Lyon Co.* v. *United States, supra,* the Supreme Court faced a complicated set of facts. Worthen Bank & Trust Company wished to have a building constructed for its banking business. As a consequence of state and federal regulation, Worthen was forced to use a sale-and-leaseback arrangement in order to raise the funds necessary for the construction of the building. Worthen, taxpayer Frank Lyon Co., First National City Bank, and New York Life Insurance Company executed complementary and interlocking agreements. The bank building was sold by Worthen to taxpayer Lyon as it was constructed. The land on which the building stood was leased by Worthen to Lyon. Worthen leased back from Lyon the completed building under a "net lease." City Bank provided the financing to taxpayer Lyon for the construction of the building, and New York Life was to become the permanent lender by purchasing the mortgage note from City Bank.

It happened that under these agreements the sum stated to be rent payments on the building over the term of the lease equalled the principal and interest payments that would amortize the New York Life mortgage loan over the same period of time. The Commissioner disallowed the interest and depreciation deductions that taxpayer Lyon took as the purported owner of the bank building on the ground that taxpayer Lyon was not the owner for the purposes of the tax law. The Eighth Circuit agreed with the Commissioner.

The Supreme Court reversed, holding that taxpayer Lyon was entitled to the deductions as the owner of the building. The Supreme Court determined that the substance of the transaction was a bona fide sale-and-leaseback.

There is a superficial similarity in the present case to the *Frank Lyon Co.* case. In both cases, the payments were equal to the discharge of the mortgage indebtedness on the property. The very reasons that the Supreme Court gave in Part III of its opinion, 98 S.Ct. 1299-1302, supporting its con-

clusion in that case, however, clearly distinguish the case from the one before us.

First, the Supreme Court noted that it was taxpayer Lyon alone, and not Worthen, which was liable on the mortgage note to New York Life. In the words of the Supreme Court:

> Here . . . and most significantly, it was Lyon alone, and not Worthen, who was liable on the notes, first to City Bank, and then to New York Life. Despite the facts that Worthen had agreed to pay rent and that this rent equalled the amounts due from Lyon to New York Life, should anything go awry in the later years of the lease, Lyon was primarily liable. No matter how the transaction could have been devised otherwise, it remained a fact that as the agreements were placed in final form, the obligation on the notes fell squarely on Lyon. Lyon, an ongoing enterprise, exposed its very business well-being to this real and substantial risk.
>
> The effect of this liability on Lyon is not just the abstract possibility that something will go wrong and that Worthen will not be able to make its payments. Lyon has disclosed this liability on its balance sheet for all the world to see. Its financial position is affected substantially by the presence of this long-term debt, despite the offsetting presence of the building as an asset. To the extent that Lyon has used its capital in this transaction, it is less able to obtain financing for other business needs.

98 S.Ct. at 1300. In contrast, in the present case, the taxpayers were not liable on the notes to the lenders, either on a recourse or non-recourse basis. The corporations alone were the liable parties.

Second, the Supreme Court noted that the accounting treatment in the case before it was consistent with a sale-and-leaseback. The Supreme Court acknowledged that accounting descriptions did not give substance to what had no substance, but then pointed out that the use of accepted accounting

methods in accordance with the form of the agreement gave the transaction a meaningful character because the parties understood the accounting treatment to be appropriate for a sale-and-leaseback. Again in contrast, the accounting treatment in the present case was not employed by the parties as the appropriate method to account for a sale-and-leaseback. Here the accounting treatment only served to confuse matters.

Finally, the Supreme Court noted that there were independent parties involved in the case before it and that these parties had negotiated at arm's length. The sale-and-leaseback agreement between Worthen and taxpayer Lyon was a product of those arm's-length dealings, not of collusion with the sole design of cutting taxes. That the agreement between Worthen and Lyon involved tax planning did not bother the Supreme Court because Worthen and Lyon were independent parties. It is pertinent here to quote the Supreme Court's language in *Frank Lyon Co.* on the independent status of the parties.

> Lyon is not a corporation with no purpose other than to hold title to the bank building. It was not created by Worthen or even financed to any degree by Worthen.

98 S. Ct. at 1302. In contrast, in the present case the taxpayers and the corporations were not independent parties. Taxpayers controlled the corporations.

In light of these clearly distinguishing points, the *Frank Lyon Co.* case is not support for the taxpayers in the present case. In fact, it may not be inaccurate to suggest that the true relevance of the *Frank Lyon Co.* case here is that none of the factors enumerated by the Supreme Court in *Frank Lyon Co.* for upholding a sale-and-leaseback arrangement were present in the situation before us. At this deeper level of analysis, *Frank Lyon Co.* supports this Court's decision in the present case.

The Tax Court's case *Bolger* v. *Commissioner, supra,* 59 T.C. 760, is not quite so easily distinguishable as *Frank Lyon Co.*

In *Bolger,* ten corporations acquired desired properties and in each case a net lease arrangement was subsequently made with a manufacturing or commercial concern interested in the use of the particular property. The corporations then sold all of their notes, in an amount equal to the purchase price of the property it had acquired, to institutional lenders, which would be secured by a first mortgage and an assignment of the lease. The mortgage notes included provisions for the payment of the mortgage over a period equal to the term of the lease, for the corporation to maintain its existence and to refrain from any business activity except that which arose out of the ownership and leasing of the property and for the payments by the lessees on the leases to be made directly to the mortgagee in satisfaction of the secured notes.

After the lease and mortgage arrangements were made, the corporations conveyed the property to the shareholders for "one dollar and other consideration." In accordance with the terms of the mortgage agreement, the transferee shareholders executed an assumption agreement in favor of the corporation, promising to assume all of the corporation's obligations under the lease and the mortgage, although on a non-recourse basis. The taxpayer-shareholder Bolger participated in this scheme and on his income tax returns for a four year period took his share of the income and deductions as a co-owner of the properties. The Commissioner, however, disallowed the depreciation deductions taken by the taxpayer Bolger, who appealed to the Tax Court. There it was determined that the corporations were all viable entities both before and after the transfer of the properties and hence had to be treated as separate entities and that the corporations had transferred what ownership interests they had to their shareholders.

Despite many similarities to the present case, *Bolger* is distinguishable on the same grounds that the Supreme Court enumerated in *Frank Lyon Co.* for upholding sale-and-lease-back treatment. The first distinction between *Bolger* and the present case is that in *Bolger* the taxpayer-shareholder assumed

the mortgages under the agreements that transferred the properties from the financing corporations. Here the mortgage liabilities were not assumed. While it may be true that the *Bolger* taxpayer and his fellow shareholders did not assume the mortgage on a recourse basis, still it was the *Bolger* taxpayer and his fellow shareholders who would be normally paying the mortgage. In the present case, the transfer and management agreements provided that the corporations make the payments.

Second, the *Bolger* taxpayer accounted for the income and expenses of his interest in the buildings in accordance with his claimed interest; the *Bolger* taxpayer adopted an accounting method that reflected his intention that he be treated as an owner of the properties. The accounting treatment adopted in the present case had the corporations and not the taxpayers reporting the gross income and expenses of operating the apartments when the taxpayers claimed that the corporations were merely their agents; questions therefore arose as to whether the corporations or the taxpayers owned the apartments.

Third, in *Bolger,* there was not an issue as to whether the substance of the agreements transferring the properties from the corporations to the shareholders were different from the form. Rather, the issue was whether the corporations in that case could transfer a present interest in the properties given the encumbrances in the assignments of leases and the mortgages. The Tax Court said yes. Here the issue was whether the corporations had transferred the ownership of the apartments in view of the agreements between the parties. Unlike the *Bolger* situation, there were questions raised as to whether the substance of the agreements comported with the form (which they did not) and whether there was a bona fide transfer.

Finally, in *Bolger,* there were a number of independent parties involved; the *Bolger* lessees were manufacturing or commercial concerns desiring to use the properties owned first by the financing corporations and then by the *Bolger* taxpayer and his fellow shareholders. There was not present a sham

sale-and-leaseback arrangement between related parties, as there was in the instant case. While *Bolger* is closer to the case before us now than *Frank Lyon Co.*, there are no problems with drawing a line between this case and *Bolger*, which in any event is not binding on us.

The decision of the Tax Court is affirmed. Each party is to pay his own costs.

APPENDICES

FILED

DEC 5 1978

JOHN P. HEHMAN, Cler'

NO. 76-2283

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

MACLIN P. DAVIS, JR., and DOROTHY S. DAVIS; LAURENCE B. HOWARD, JR., AND CORNEILLE T. HOWARD; ALLAN MURPHY and ESTATE OF MARION E. MURPHY by ALLAN MURPHY, Executor

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE

Appellee

ORDER

- - - - - - -

Before: EDWARDS and KEITH, Circuit Judges, and PECK, Senior Circuit Judge.

Upon the consideration of the petition for rehearing filed herein by appellants, the Court concludes that the issues raised therein were fully considered upon the original submission and decision of this case.

It is therefore ORDERED that the petition for rehearing be and it hereby is denied.

ENTERED BY ORDER OF THE COURT

John P. Hehman

John P. Hehman, Clerk of Court

No. 78-1173

In the Supreme Court of the United States

OCTOBER TERM, 1978

MACLIN P. DAVIS, JR., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530

In the Supreme Court of the United States

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The question presented in this federal income tax case is whether the purported transfer of residential apartment complexes by three corporations to their stockholders was sufficient to shift the income and deductions attributable to that realty to petitioners, who are the shareholders of the corporations.

The pertinent facts are as follows: Petitioners are stockholders in three corporations, which were formed to obtain financing, construct, and manage apartment projects pursuant to programs established by the Department of Housing and Urban Development to provide housing for low and moderate-income families (Pet. App. B-2).[1]

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[1]See National Housing Act, Section 221(d)(3), 12 U.S.C. 1715*l*(d)(3).

All three corporations obtained loans to finance 100 percent of the construction costs from private mortgage companies, with the Federal Housing Administration (FHA) acting as guarantor of the loans (I-R. A51-A53). Each corporation entered into a "regulatory agreement" with the FHA, which provided that the approval of the Federal Housing Commissioner would be required for the adoption of rental schedules; the conveyance, transfer, or encumbrance of the property of the project; and any contract for supervisory or managerial services (see, *e.g.*, Joint Ex. 9-I; I-R. A143).[2]

The corporate form of ownership prevented the shareholders from claiming the benefits of the net tax losses generated by the property. Accordingly, after the completion of construction, the corporations entered into an agreement with the stockholders purporting to transfer their interest in the apartment property to the stockholders, as tenants in common, in proportion to their respective shareholdings. The pertinent portions of the agreements (all of which were substantially the same) provided that the transfers were to be made by deed, that the corporations would continue to be liable on the mortgage notes, that the corporations would remain fully responsible to the FHA for the regulatory agreements, and that each corporation would continue to possess and manage and maintain its respective apartment complex (I-R. A151-A152, A171-A172; II-R. A192-A193). Quitclaim deeds from the corporations to the shareholders were executed, but were not recorded (III-R. A369, A374, A538). Although the Federal Housing Commissioner was advised of the execution of the deeds (II-R. A358, A360; III-R. A362), the corporations never received the approval required by the regulatory agreements (Pet. App. B-5).

[2]"R." refers to the three-volume record filed in the court of appeals.

On their tax returns filed for the year in question, each corporation reported as income the gross rents received from its respective apartment project, and claimed deductions for most of the operating expenses (III-R. A509-A514; IV-R. A703). The deductions claimed included amounts characterized as "Management Fees" (II-R. A321), "Fees paid to tenants in common" (II-R. A311), or "Rental on Apartment Property" (II-R. A294) which actually represented payments of interest and principal made on the mortgage loans (see II-R. A208).

Those "fees" were in turn reported as "income from rents" on partnership returns filed by petitioners.[3] From that "income," the partnerships deducted the interest portion of the mortgage payments, depreciation, and incidental expenses. In each case, the deductions claimed exceeded the income, resulting in a net loss to the partnership which was then allocated among the partners (II-R. A208; IV-R. A700, A701).

On audit, the Commissioner of Internal Revenue disallowed petitioners' claimed deductions for their pro rata shares of the 1969 losses attributable to the three apartment properties on the ground that the transfer of title from the corporations to petitioners were sham transactions (I-R. A16, A19, A22, A33, A37) so that the beneficial ownership of property remained in the hands of the corporations. The Tax Court upheld the Commissioner's determination (Pet. App. A-1 to A-13) and the court of appeals affirmed (Pet. App. B-1 to B-18).

1. The decision below correctly held that the income and deductions attributable to the apartment properties had to be reported by the corporations and not by

[3]Partnership returns were filed for Hillside Apartments Company, a partnership composed of the shareholders of Harpeth, Inc.; Bedford Apartments Company, composed of the shareholders of Bedford Manor, Inc.; and Urban Apartments Company, composed of the shareholders of Urban Manors East, Inc. (IV-R. A699, A700, A701-A702).

petitioners. As the court of appeals pointed out (Pet. App. B-9), the transfers of title from the corporations were not the result of arms-length negotiations between independent parties. Simply put, the corporations would not have entered into those agreements had they not been controlled by petitioners to whom the transfers were made. There were no visible, appreciable benefits to the corporations. Petitioners gave no consideration for transfers, and the corporations were not relieved of the burdens of ownership of the apartment properties.

Moreover, the transfers of title made no significant change in the economic relationships of the parties involved. Most of the attributes of the ownership of the apartment property remained with the corporations under the terms of the transfer agreements. The deeds were not recorded, so that record title remained in the corporations. Each corporation continued to possess the property and was solely responsible for all maintenance and repairs at its own expense. The corporations alone were liable on the mortgage notes. The stockholders did not assume any part of the corporations' responsibility to the FHA under the regulatory agreements. Indeed, the transfer agreements expressly provided that the corporations' obligations were to continue exactly as if no transfers had been made. And, finally, there were no substantial business reasons, other than tax avoidance, for these transactions. As the Tax Court found (Pet. App. A-7), the sole purpose of the nominal title transfers was to enable the stockholders to use the interest and depreciation deductions generated by the projects to shelter other individual income.[4]

[4]Petitioners argue (Pet. 8) that Congress intended to provide exactly the tax shelter benefits sought here. As the court of appeals noted (Pet. App. B-9 n.7), however, the legislative intent was to provide tax benefits to the true owners of low income rental housing, not to validate transfers of title that have no economic substance.

2. Contrary to petitioners' contention (Pet. 6-8), the decision below does not conflict with *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978). There, the Court held that an arrangement under which a bank constructed a new office building and sold it to the taxpayer, who in turn leased it back to the bank, was not a sham, and was sufficient to shift the incidents of ownership of the property to the taxpayer who could thereby report the income and deductions attributable to the property. In so concluding, the Court found persuasive facts that the transaction placed the risks normally associated with building ownership upon the taxpayer, because it was taxpayer alone who was liable on the mortgage note and who bore the risks of building depreciation (*id.* at 577, 581); that the entire sale and leaseback arrangement and the terms of the various agreements were the result of extensive bargaining between independent parties (*id.* at 582); that there was substantial economic motivation apart from tax considerations for the structure of the transaction because the bank had been denied permission by the Federal Reserve System to construct the building using more conventional methods of financing, and that one of the taxpayer's principal reasons for entering the transaction was its desire to diversify (*ibid.*). Since none of these factors is present in the instant case, *Frank Lyon Co.* is distinguishable.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

MARCH 1979